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MEMORANDUM

TO: MARC LELAND

FROM: PAUL KRUGMAN

Subject: LDC Debt Problems

Attached is a revised version of the debt-trade paper. I have attempted to take into account the comments from Korp, Ammerman, and Fauver.

cc:
Jim Ammerman
Bob Fauver
Ralph Korp

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DRAFT 12/9/82

EFFECTS OF THE DEBT PROBLEM ON U.S. TRADE

Summary

The slowdown in lending to less developed countries will force these countries to reduce their borrowing needs by reducing imports and increasing exports. In the short run imports will bear the main burden of adjustment.

Reductions in LDC imports will have a genralized depressing effect on world trade and output. We estimate that credit constraints on non-oil LDCs could, via their direct and indirect efects, ultimately reduce U.S. exports by as much as $14 billion and reduce U.S. real GNP growth by up to 0.9 percentage points. This full adjustment would occur over a 1-2 year period.

In the longer run U.S. exports will recover, but LDCs will increasingly shift from import restriction to export promotion. Based on past trade patterns, the U.S. may have to absorb $9 billion or more of these additional exports from LDCs, much of it in imports of manufactured goods.

These numbers assume that a severe but manageable cutback in private lending occurs, with IMF and other official assistance sufficient to avoid financial crisis. The required adjustments could be greatly reduced by substituting massive official financing for private lending, but this is unrealistic and undesirable. On the other hand, an even more severe

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cutback in lending would have serious financial and political risks.

The size of the impact on the U.S. economy may be less than our estimates if the international effort to bring about a balance of adjustment and financing is successful. However, a substantial depressing effect on U.S. exports and a substantial drag on U.S GNP will still occur. The negative effect on the U.S. trade balance cannot be avoided; it is an inevitable result of the adjusment process in LDCs and must be accepted by the U.S. In particular, the U.S. must be willing to absorb more imports from the LDCs. Protectionism against these countries would risk provoking a financial crisis.

1. <u>Background</u>

A loss of confidence by international lenders is sharply reducing the flow of capital to less-developed countries. As a result, LDCs will be forced to lower their borrowing needs by reducing their current account deficits. They will probably accomplish this by adopting domestic austerity programs, devaluing their currencies in some cases, and most probably also by more widespread use of import rstrictions and export susidies. In the short run most of the adjustment will come on the import side, leading to a lower volume of world trade than would otherwise have been the case. One aspect of this contraction will be a decline in U.S. exports, which may contribute substantially to the already forecast widening U.S. trade deficit in 1983 and may also significantly slow U.S. recovery.

Debt problems are not evenly spread across the less-developed world. Most LDCs will be little affected by the lending slowdown, either because their debt is small relative to exports or because they are mostly financed by public sources such as the IBRD, aid flows, export credits, etc. Thus the impact of reduced lending will tend to fall primarily on a small group of Latin American countries which have relied on sizable commercial bank borrowing, and are likely to be constrained in their future borrowing. For the purposes of this paper, we have identified a group of six "Credit Constrained Countries" (CCCs): Argentina, Brazil, Chile, Mexico, Peru, and Venezuela.

Table 1 presents some background data on the CCCs. Several points are worth noting:

- The total debt of the CCCs increased more rapidly during the 1970s than that of other LDCs (24.5 versus 15.8 percent). Although exports also grew rapidly, the ratio of debt to exports rose substantially.
- The debt-export ratio of the CCCs is much higher than that of LDCs as a whole. Also, a higher proportion is private debt, subject to problems of confidence: 88 percent vs. 54 percent. Thus the potential severity of liquidity problems for those countries is much more severe than looking at all LDCs as an aggregate would indicate. In particular,

the CCCs face debt service payments (including repayment of short-term debt) which exceed exports, so that it will be impossible for them to service existing debt without substantial new lending.

- Finally, the CCCs are much more closely tied to the U.S. than LDCs as a group, as reflected in the high percentage of their imports coming from and exports going to the U.S. This means that the effects of the lending slowdown will fall particularly heavily on U.S. trade.

Table 1: Background Data on Credit Constrained Countries

Total debt: ($ billion)	1973	39
	1981	226
	Rate of increase	24.5%
Exports: ($ billion)	1973	18.0
	1981	76.0
	Rate of increase	19.7%
Debt as a % of exports:	1973	217
	1981	297
Debt service as a % of exports:	1982	120 (estimate)
Trade balance ($ billion)	1981	3.1
% of imports coming from U.S.:	1980	37.3
% of exports going to U.S.:	1980	35.6

2. <u>The Likely Extent of the Lending Slowdown</u>

The principal source of uncertainty in assessing the likely effects of the lending slowdown is that we do not know

how much finance will actually be available. One study (by the OECD) has suggested that net new lending in 1983 to all LDCs may be only $10 billion below its 1981 levels. Other studies have considered the possibility of zero net private lending, implying a fall in financing of some $50 billion to all LDCs, and more than $35 billion to the CCCs. In theory, the financing constraint could be even tighter, with banks trying to require net repayment.

There are, however, two factors which probably insure that the lending slowdown will lie between these extreme estimates. The first is that too severe a borrowing constraint will lead to forced rescheduling by the major debtors. The CCCs typically have private debt equal to more than twice their exports of goods and services, and have in the past been able to expand that debt by some 20 percent per year. Cutting net lending to zero would require cutting imports by 40 to 50 percent, requiring some combination of huge devaluations, sharp reductions in domestic output, and/or very tight import controls. Debtor countries are unlikely to be willing to do this, especially since the CCCs are currently running trade surpluses.

On the other hand, it is extremely doubtful whether lenders will be willing to extend credit at rates close to those of 1981, as suggested by some optimistic observers. Given the perceived risks, banks will be unwilling to actually increase their exposure in LDCs relative to other loans. Morgan Guaranty has suggested 10 percent as an optimistic rate

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of growth of private lending; this would imply a cutback of $15 to $20 billion in the borrowing of the CCCs. In fact, the cutback could be more severe than this. Although the large banks may try to expand lending to avert defaults, smaller banks will try to act as "free riders" and withdraw their funds. Informal pressures will help limit the capital flight, but it is unlikely that overall private debt of the CCCs can expand at much more than 5 percent.

There is a definite possibility that the "ceiling" growth of debt imposed by the confidence problems of lenders could turn out to be lower than the "floor" on CCC borrowing set by the ability and willingness of debtors to improve their trade balances. If IMF financing cannot fill the gap there could be stoppages of payment by debtor nations, declarations of debt moratoria, massive reschedulings, and in the extreme repudiation of debt by a few countries. For the purposes of this paper, we will assume that this will not happen. Instead, we assume that there is a severe slowdown in lending but that the borrowing countries are able to live within this constraint. The largest reduction in lending to the CCCs which we believe is consistent with non-default is $25 billion. (This is a deliberately pessimistic number relative to estimates by other studies.)

For the rest of this paper, then, we will work with the assumption that the financial constraints on the CCCs require them to cut their collective trade deficit by $25 billion. It

must be stressed that this remains an assumption; thus the numbers which we present are rough orders of magnitude based on that assumption, not firm projections. But the results are proportional to the assumed lending cutback and can thus be scaled up or down to estimate the effects of alternative assumptions.

3. Short-Run Effects of the Lending Slowdown

In the short run, less developed countries finding themselves constrained in their borrowing will primarily react by cutting imports rather than by expanding exports. This will reflect differences in timing: expansion of exports requires time to extend markets and in the case of agricultural commdities may have to wait until a new planting and harvest have gone by. On the other hand, imports can be rapidly reduced through controls such as quotas and by direct domestic economic contraction.

The initial effect of an import cut will be that U.S. exports to the CCCs will fall roughly in line with the U.S. share in their overall imports. Since the U.S. accounts for 37 percent of CCC imports, a $25 billion reduction in these imports would reduce U.S. exports by $9.2 billion.

This does not, however, capture the full effect. World trade would contract by considerably more than $25 billion, because of a series of indirect effects:

(i) The CCCs trade with each other. As each country restricts its imports, it will reduce the exports of the

others, forcing further cuts.

(ii) The reduction in CCC imports will depress economic activity in the rest of the world, leading to further declines in trade. U.S. exports to other industrial countries and OPEC will fall.

(iii) The decline in world trade will lead to further declines in CCC exports, forcing further import cuts and generating another round of contraction.

The magnitude of these indirect effects is obviously crucial. Some observers have expressed concern that debt problems could lead to a massive downward spiral in the world economy. To evaluate these concerns, the CEA has carried out a small-scale simulation of debt-trade linkages and estimated the effect of a $25 billion cutback in lending.

The analysis distinguishes five trading regions:

(i) The six credit-constrained countries;

(ii) other non-oil developing countries;

(iii) OPEC;

(iv) the United States;

(v) other industrial countries.

Each region's level of output, through its effects on imports, affects the output of all the others. Thus the indirect effects discussed above are taken fully into account.

Table 2 reports the effects on world trade of a $25 billion reduction in lending to the CCCs. The indirect effects are substantial: world trade declines by more than twice the

initial contraction. U.S. exports decline by 55 percent more than looking only at the direct effects would suggest. However, fears of a massive downward spiral in world trade appear to be unjustified. The total decline in world exports is only about 3 percent, reflecting the fact that the CCCs are a small part of the world economy (less than 6 percent of the GNP of the market economies).

Table 2: Reduction in Exports From a $25 Billion Lending Cutback
($ billion)

CCCs	3.7
OPEC	8.4
Other LDCs	5.1
U.S.	14.3
Other industrial countries	27.8
World Trade	59.3

Table 3 shows the sources of the decline in U.S. exports. Note that the decline in exports to the CCCs is somewhat larger than the original $9.2 billion; this is because the contraction in CCC exports forces further cuts in their imports. Reduced exports to other areas make up the extra fall. We should also notice that the fall in U.S. exports will induce a decline in GNP which in turn leads to a partially offsetting decline in imports, so that the trade balance deterioration is somewhat smaller than the impact reduction in exports. The CEA's simulation predicts a fall in U.S. GNP of 0.9 percentage points from what it would have been in the absence of the debt problem.

Table 3: Sources of Decline in U.S. Exports
($ billion)

Reduced exports to:	
CCCs	10.5
OPEC	0.7
Other LDCs	0.5
Other industrial countries	2.6
Note:	
Fall in U.S. imports	4.0
Change in U.S. trade balance	10.3

4. Longer-Run Effects

Over the longer run the nature of the effects of the lending slowdown will tend to shift in character, as eventual adjustment is reached. Two major factors will lie behind this shift. First, the self-correcting character of the economies of the industrial countries will produce a recovery in output and trade. Second, the credit-constrained countries will shift from import restriction to export promotion.

Recovery in the industrial countries will come via lower interest rates. By depressing demand in the industrial countries, the lending slowdown will reduce the demand for money, lowering interest rates; these lower rates will eventually lead to partially offsetting increases in interest-sensitive components of spending, such as investment, housing, and consumer durables. Over a still longer run, depressed output will mean lower inflation, leading to rising real money balances which will further lower interst rates. The eventual result will be that the indirect effects stressed in the previous section will die out.

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At the same time, the CCCs will be attempting to shift from import restriction to export promotion. A good first approximation would be that all of the adjustment to lower capital inflow will eventually take the form of increased exports rather than reduced imports. The reason is that several of the CCCs are already importing very little relative to their GNPs, because of restrictive trade policies. Table 4 gives some illustrative comparisons. Note that Argentina and Brazil actually import less than the U.S., even though the U.S. economy is far larger and more diversified. It is also worth noting that from 1974 to 1981 the volume of imports into Brazil actually fell by 15 percent, even though real GDP grew by 42 percent. The point is that there is very little left to cut. The IMF has traditionally required trade liberalization-cum-devaluation programs as a way of shifting from import restriction to export promotion, and will probably do the same in this case.

Table 4: Imports as a Percent of GDP, 1980

Argentina	9.1
Brazil	9.1
Mexico	13.5
Korea	43.5
U.S.	11.0

The long-run effects of the debt problem on U.S .trade are, if possible, even more uncertain than the short-run effects. If we assume, howver, that: the required CCC trade balance continues to be $25 billion higher than would otherwise

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be the case; the output of industrial countries recovers from the initial depressing effects; and the improvement in trade balances is achieved entirely through exports, an estimate is possible. We estimate on the basis of past trade patterns that in that case the U.S. would have to absorb at least $9 billion in additional imports from the CCCs. Much of this increase would probably come in non-traditional exports, especially manufactured goods, rather than in traditional primary product exports.

5. Policy Implications

The slowdown in lending to LDCs will have substantial effects on U.S. trade. Initially this will manifest itself as a decline in U.S. exports; in the longer run the U.S. will have to accept a larger volume of imports from LDCs.

There is no practical way for the U.S. to avoid these effects. An increased deficit in the U.S. trade balance is a necessary counterpart to the adjustment process in debtor countries. The only way to avoid this process would be for the advanced countries to substitute massive official financing for the cutbacks in commercial financing, a course which seems both unrealistic and undesirable. If current international efforts to bring about a balance between financing and adjustment are successful, the effects may be smaller than the CEA's estimates. Any plausible estimate of available financing and LDC adjustment will, however, still imply a subsantial effect on U.S. trade.

The most important implication may be for trade policy.

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The U.S. and other industrial countries must not respond to LDC attempts to increase their exports with protectionist measures. This would amount to the advanced nations prohibiting, with one hand, the adjustment that their banks are demanding, with the other. In addition to its usual costs, protectionism in the current context would threaten to provoke a financial crisis.

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